Islamic Finance news

A REDmoney Product

Vol. 5, Issue 36 12th September 2008

The World's Global Islamic Finance News Provider

Pakistan: Polishing a Gem

While Pakistan has been persistently associated with violence and unrest, US investment bank Goldman Sachs has this to say about the Muslim nation: "Superficially, Pakistan does not look that attractive for investment, but when you study the country, you see the possibilities." With a total population of 170 million and a GDP per capita of around US$2,900, its economy has been growing at about 7% annually since 2004.

Pakistan is seen as a member of the "Next 11", a group of emerging markets with the potential to become the world's largest economies, alongside Brazil, Russia, India and China. In this respect, Islamic finance has great potential, especially with it also being home to some of the most respected Shariah scholars.

"We regard Pakistan as the Islamic finance causeway between the GCC and the Far East," declared Rushdi Siddiqui, global director of the Dow Jones Islamic Market Index Group, when he launched the Dow Jones JS Pakistan Islamic Index.

As our country reports reveal, Pakistan was among the first countries to build a financial system according to Shariah principles, as far back as the 1970s. It has, however, turned out to be tough going, especially with several changes in government. The result is that GCC countries and Malaysia have sped past Pakistan in putting Islamic finance into active practice.

However, the surge in interest in Islamic finance around the world has sparked a revitalization of advances in this field in Pakistan. The State Bank of Pakistan has declared that it wants to develop a progressive and sound Islamic banking system that is in line, and compatible, with the global financial sector, providing innovative Shariah compliant products and services to achieve equitable economic growth. The pace is indeed picking up: There are six full-fledged Islamic banks and 12 conventional banks with standalone Islamic banking branches, while applications by a few more players are under consideration.

Our focus article, on how Shariah governance empowers Islamic finance, explains why the requirements, while being religious in origin, are a boon to all participants in the financial sector who prefer ethical, above board practices that promote good business. It also tells of how strong political will set the pace in enabling the emergence of Malaysia, Singapore, London and Hong Kong as the newest Islamic financial centers.

Even so, it speaks of the difficulty in convincing regulators to adopt Shariah governance as a policy tool, as they cannot fathom the significance of Shariah governance in setting the design for Islamic financial regulatory and supervisory work. The article warns that allowing Shariah governance to run its own course will undermine the integrity of the Islamic financial system, and says this is why government agencies need to have regulatory and supervisory duties to ensure Shariah governance in an Islamic finance framework.

An IFN Report reveals that the US government's takeover of Fannie Mae and Freddie Mac shows no immediate effect on Shariah compliant mortgages there. Both the Federal National Mortgage Association and the Federal Home Mortgage Corporation were Islamic finance intermediaries. They had purchased Shariah compliant mortgages from financial institutions which enabled providers to originate further mortgages.

In this issue

Evolution of the Islamic Banking Industry in Pakistan

By Aisha Khalid

Pakistan was among the first countries to build a financial system according to Shariah principles. The formal progress towards the Islamization of the financial system and banking in Pakistan began in late 1970s. However, as it was a massive task, the switchover plan was implemented in several phases. The Islamization measures included introduction of multiple regulations aimed at eliminating or, at least, reducing the element of interest (riba) from the operations of specialized financial institutions managed by the government and commercial banks during early 1980s.

Meanwhile, the legal framework of Pakistan's financial and corporate system was amended to permit issuance of an interest-free instrument of corporate financing. The most noticeable step was the permission to establish Mudarabah companies and floatation of Mudarabah certificates to raise risk-based capital. Amendments were also made to the banking regulations to include a provision for bank financing through profit and loss sharing accounts, leasing and hire purchase.

Meanwhile, separate counters were started in all the nationalized commercial banks and one foreign bank to mobilize deposits on a profit and loss sharing basis. Regarding investment of these funds, banks were instructed to provide financial accommodation for government commodity operations under Islamic principles.

During that same period, financing of import and inland bills for the government commodity corporations were shifted to mark-up basis. Simultaneously, necessary amendments were made to the related laws permitting the State Bank to provide finance against Islamic instruments. Meanwhile, banks were allowed to provide finance to meet the working capital needs of trade and industry on a selective basis under the principles of Musharakah.

During the 1980s, almost all Pakistani rupee financing transactions conducted by the banking industry was Shariah compliant with a crude

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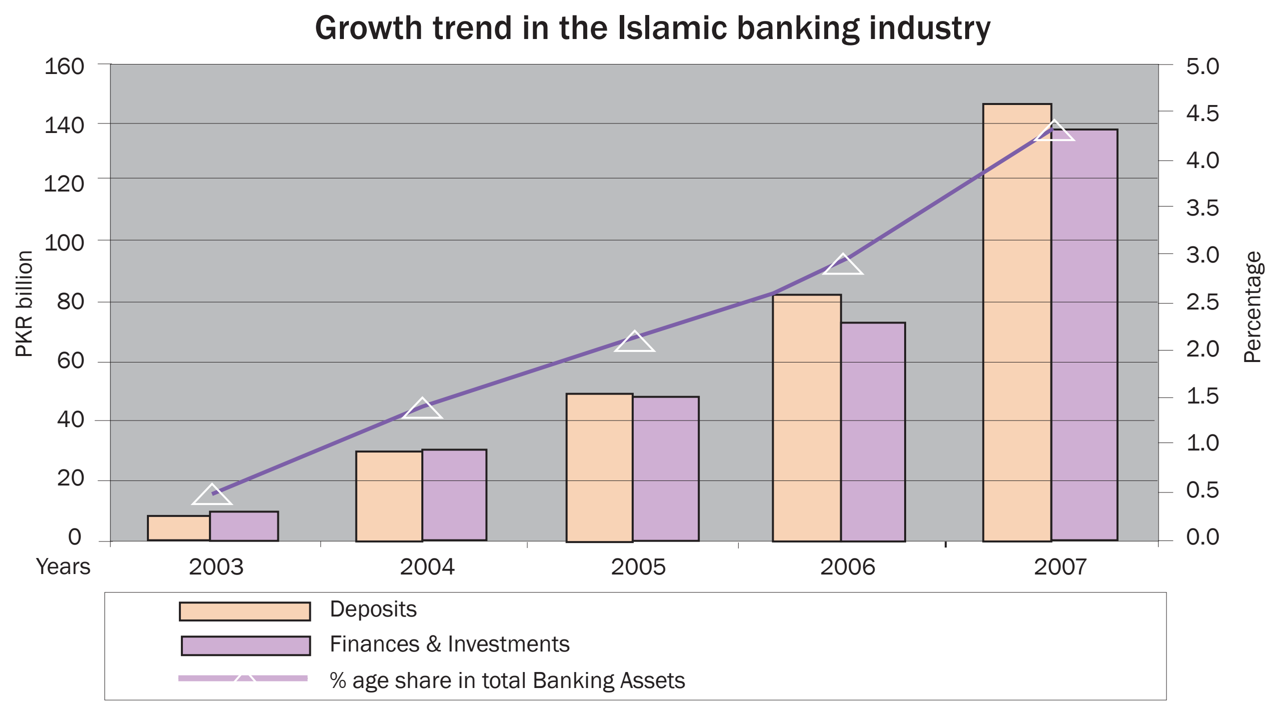

(Pakistani Rupees in billions)

Description	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07
Total Assets	13	44	72	118	206
% age of Banking Industry	0.5%	1.4%	2.1%	2.9%	4.3%
Deposits	8	30	50	83	147
% age of Banking Industry	0.4%	1.2%	1.9%	2.8%	4.1%
Financing & Investment	10	30	48	72	138
% age of Banking Industry	0.5%	1.3%	1.8%	2.4%	3.6%
Full-fledged Islamic Banks	1	2	2	4	6
Conventional Banks with Islamic Banking Branches	3	7	9	12	12
No. of Branches	17	48	70	150	289

Evolution of the Islamic Banking Industry in Pakistan (continued)

explanation of Islamic finance. However, this was merely a change of nomenclature but, in essence, nothing really changed. Moreover, foreign currency deposits in Pakistan and on-lending of foreign loans continued as before. However, after a few years, the procedure adopted by the banks in Pakistan, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared unIslamic by the Federal Shariat Court (FSC).

Nevertheless, appeals were made in the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan, which rejected the appeals and directed that laws involving interest be eliminated by 2001. In the judgment, the court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. It also directed the government to set up, within a specified timeframe, a commission for transformation of the financial system and two task forces to plan and implement the transformation process.

It was decided later that the shift to an interest-free economy would be made in a gradual and phased manner and without causing any disruptions. Accordingly, the State Bank of Pakistan (SBP) issued detailed criteria for the establishment of full-fledged Islamic commercial banks in the private sector. SBP issued the first Islamic commercial banking license in 2002 to Meezan Bank, which started its operations in the same year.

Regulatory structure of the Islamic banking industry

The SBP wants to develop a progressive and sound Islamic banking system that is in line, and compatible, with the global financial sector, providing innovative Shariah compliant products and services to achieve equitable economic growth. Its Islamic banking department, established in 2003, has been entrusted with promoting and developing Shariah compliant Islamic banking as a parallel and compatible banking system in the country.

Currently, the Islamic banking department four divisions: policy; Shariah compliance; business support; and Shariah board secretariat. The SBP has issued detailed instructions and guidelines for Shariah compliance and risk management, whereas work on similar rules for corporate governance, prudential regulations, accounting & Shariah standards etc regarding Islamic banking is underway.

Pakistan's Islamic banking industry

Islamic banking is one of the emerging fields in global financial markets, having tremendous potential and growing at a very fast pace. The progress of Islamic banking in Pakistan has likewise been commendable in the last few years. Currently there are six licensed full-fledged Islamic banks and 12 conventional banks with standalone Islamic banking branches with the total branch network of over 280 branches, while applications by a few more players are under consideration.

Islamic banking is a high priority area for the SBP. Steps are being taken to make the Islamic banking industry in Pakistan robust enough to offer a viable alternative to conventional banking, should the market decide that Pakistan should have an exclusive Islamic banking system in the country.

One of the biggest challenges being faced by this growing industry is the dearth of professional Islamic bankers and capacity building in this regard is one of the top most priorities for the promotion of Islamic banking.

Recently the SBP has also issued guidelines for Islamic microfinance and draft guidelines on Islamic financing for agriculture.

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